

VZCZCXRO4271
PP RUEHDE
DE RUEHAD #1472/01 1051201
ZNY CCCCC ZZH
P 151201Z APR 06
FM AMEMBASSY ABU DHABI
TO RUEHC/SECSTATE WASHDC PRIORITY 4539
INFO RUEHDE/AMCONSUL DUBAI 6031
RHEHNSC/NSC WASHDC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

C O N F I D E N T I A L SECTION 01 OF 04 ABU DHABI 001472

SIPDIS

SIPDIS

STATE FOR NEA/ARPI, EB/IFD/OMA
STATE PLS PASS TO USTR FOR SDONNELLY, DBELL, KCLAYMAN
TREASURY FOR U/S QUARLES, RAMANATHAN

E.O. 12958: DECL: 04/15/2016
TAGS: [EFIN](#) [EINV](#) [ETRD](#) [ECON](#) [AE](#)
SUBJECT: TREASURY U/S QUARLES VISIT TO UAE

Classified By: Ambassador Michele J. Sison for reasons 1.4 (b) and (d).

¶1. (C) Summary. During Treasury Under Secretary Quarles' March 22 meetings, his interlocutors stressed their belief that the U.S. - UAE relationship was strong and that government investors in the UAE would continue to invest in U.S. assets, despite DP World. Over ninety-eight percent of the Central Bank's \$23 billion in foreign exchange reserves are in dollar denominated assets, and the Governor has no plans to change that allocation in the near term. ADIA currently holds \$3.7 billion in inflation indexed bonds and about \$4 billion in nominal bonds, and is plowing about 50% of its oil revenues into dollar assets. UAE investors do have concerns about the impact of the Patriot Act of the security of their investments in the U.S. and are likely to re-examine some potential direct investments in light of DP World to ensure that they "go smoothly." While he is willing to consider DP World an anomaly, Dubai Holdings CEO Gergawi is looking at the response to a pending purchase of Doncasters Ltd. as an indication of how open the U.S. really is to foreign investment. End summary.

¶2. (C) On March 22, Treasury Under Secretary for Domestic Finance Randal Quarles, Treasury financial economist Karthik Ramanathan, and Abu Dhabi Econchief met with Central Bank Governor Sultan Nasser Al-Suwaidi, MinState Finance Dr. Mohammed Khalfan bin Kharbash, Abu Dhabi Investment Authority (ADIA) Deputy Managing Director Khalifa Al-Kindi, MinState Cabinet Affairs (and Dubai Holdings CEO) Mohamed Al-Gergawi, and Dubai Investment Group CEO Saud Ba'alawy. Ambassador accompanied on meeting with Governor Al-Suwaidi and CG accompanied on meeting with MinState Gergawi. U/S Quarles explained that he was visiting the region in order to reach out to investors in the U.S. especially holders of U.S. treasury securities. His interlocutors all stressed the close relationship between the U.S. and the UAE and the UAE's continued interest in investing in the U.S. despite the recent problems with DP World.

U.S. Investments Still Attractive

¶3. (C) All of U/S Quarles' interlocutors stressed that the size and liquidity of the U.S. market ensured that it would remain the investment destination of choice for the foreseeable future. In contrast to his earlier public comments that the Central Bank would consider transferring up to 10% of its \$23 billion in reserves to Euros, Governor Al-Suwaidi stated that the Bank would keep its reserves in dollars. He explained that the UAE dirham was pegged to the dollar, and that he measured the sustainability of the peg in three ways: investment currency for the UAE, currency for its international trade, and cash requirements of tourists. By

this measure, the dollar led two to one on the Euro. Only the UAE's tourists suffered when they visited Europe, but the bank could weather those complaints. He noted wryly, "if we buy the euro, what do we do, lend to Italy? How liquid are they?"

¶4. (C) Governor Al-Suwaidi also stated that the GCC would likely maintain its dollar peg if it entered into a monetary union in 2010. In his view, it made no sense to change the peg after monetary union, since he envisioned that the common currency would move to a free float after a transition period. In a subsequent meeting, Dr. Kharbash explained that when the GCC laid its blueprint for the unified economic agreement in the late 1980s early 1990s, it had given some thought to pegging to the IMF's Special Drawing Rights. The decision had been, however, to peg to the dollar and, given the risk-averse nature of bureaucrats, he didn't see that changing.

But There Are Concerns

¶5. (C) Despite their stated support for U.S. investments, all of the interlocutors raised concerns about investing. One of the major topics of conversation was DP World. All expressed their sharp disappointment with the outcome, but stressed their appreciation for the administration's support for DP World, and their belief that the U.S. - UAE relationship would not be harmed. Al-Suwaidi noted, for example, that the result had been beyond the administration's control and was a result of mixing politics with commerce. A common theme was that, while the UAEG appreciated the USG's support, the "man on the street" was more angry and hurt and was less able to understand the political nuances behind the problems.

ABU DHABI 00001472 002 OF 004

Gergawi said that the UAE pulled out of P&O's U.S. assets since the relationship was more important than a business transaction. He added however, that "people don't like to be insulted." DP World raised issues for Arab investors such as "are we welcome or not" that needed to be addressed. He noted that the UAE business community had put pressure on the UAEG for negotiating an FTA with the U.S. arguing "what's in it for us." DP World gave the business community more ammunition.

¶6. (C) MinState Gergawi said that Dubai Holdings' real estate and hotel investments in the U.S. would continue, but that it might need to re-think investments in certain industries, to be sure that everything went smoothly. He noted that Dubai Holdings was trying to buy another UK company with assets in the U.S. (Doncasters Group Ltd). This purchase was also undergoing CFIUS review and he viewed it as a test of whether the U.S. really was open to foreign investment. He said he had a good feel about Doncasters. One of the plants was in Georgia. He had raised the deal with Senator Chambliss, who had visited on March 12, and obtained his support. At the end of the day, he said, he was trying to grow his business and not put it to a "political spin." U/S Quarles stressed that successive U.S. administrations had seen the value in foreign investment in the U.S., encouraged it as a matter of policy and were unlikely to change that policy in the future. He admitted that there would be "periods of noise," but expressed his hope that DP World would remain an anomaly.

¶7. (C) In separate meetings Al-Suwaidi and MinState Kharbash noted that the Patriot Act posed a concern for Arab investors. Al-Suwaidi opined that the end result might be to make a safer financial sector, but that he feared that it would "catch innocent people" and might make the U.S. payment system less attractive. U/S Quarles stressed that the provisions of the Patriot Act were necessary, but that Treasury did monitor the impact to ensure that it would not place undue impact on the payments system.

¶8. (C) Several interlocutors raised questions about the

continued foreign appetite for U.S. assets (in particular from the Chinese and GCC states). They also raised questions about the sustainability of the current account deficit. Al-Suwaidi asked what the impact of the U.S. efforts to have China move to a more flexible exchange rate would be on U.S. interest rates. U/S Quarles replied that he thought the impact on the U.S. ability to finance its deficit would be minimal, since historically as one investor stepped out another stepped in. He said that he believed the U.S. could sustain a current account deficit for a longer period and at a higher level than most other countries for a number of reasons: even after an extended period of running a current account deficit, net foreign claims on the U.S. were still relatively low at 25 percent of GDP; the U.S. had significant foreign investments of its own, as the dollar declined, the value of these investments increased, meaning that the net foreign investment position was not changing as quickly as the current account deficit would imply; finally the dollar was still the world's reserve currency. Although an adjustment would need to occur, as long as it was gradual, there was no expectation that it would have serious impacts on the economy. The U.S. economy had gone through a number of shocks over the last few years, but none had caused investors to suddenly decide to pull out of the market.

18. (SBU) MinState Kharbash, explaining that "things do add up" in creating a positive or a negative investment climate, raised the UAE's interest in negotiating a double taxation treaty (DTA) with the U.S. He said that he had been charged with trying to negotiate a DTA with the U.S. on behalf of the whole GCC, but that the Treasury department had turned him down, since the GCC didn't "have taxes." He added that the UAE had DTAs with France and a number of other European countries, which certainly provided an added incentive for UAE investors to look to Europe. U/S Quarles noted that he had heard similar concerns in Kuwait. He explained that the tax negotiators had to set priorities, but said he would raise the issue at Treasury.

ADIA's portfolio

19. (C) Al-Kindi stated that ADIA currently holds \$3.7 billion in TIPS (inflation linked bonds) and about \$4 billion in nominal bonds. He added that ADIA was investing about half of the current oil windfall into dollar denominated instruments. (Note: The Emirate of Abu Dhabi turns oil

ABU DHABI 00001472 003 OF 004

revenues in excess of expenditures over to ADIA to invest.) He said that ADIA had a long term perspective on investing and -- unlike the Central Bank -- had a preference for longer-term maturities. Senior Investment Advisor Jean Paul Villain noted that bonds played a role in ADIA's portfolio both as a source of return and as insurance against low probability, but highly damaging events. ADIA, he noted was attracted by inflation indexed bonds, since they were essentially no risk assets. As U.S. inflation linked bonds became more liquid, ADIA's appetite increased. He added that ADIA tended to try to keep a fairly constant flow into various asset classes and not make large sudden movements. Villain stated that ADIA's appetite for bonds extended across the yield curve.

110. (C) ADIA Executive director Salem Al-Mazroui raised the fact that some of the current GCC's current petrodollar surplus was not being recycled back to U.S. Treasury Bonds. Al-Kindi stated that Abu Dhabi still tended to look for external investments, whereas the Saudis were paying down their government debt. As long as oil is over \$30 per barrel, he noted, ADIA is not likely to undertake any major shifts. He noted, however that ADIA was diversifying into new asset classes (including small cap stocks, emerging markets, and mortgages and agencies as asset classes separate from government bonds).

¶11. (C) Villain gave some insight into ADIA's portfolio allocations, noting that ADIA had recently reduced its weight in Japanese bonds, believing that the JP Morgan index was over weighted toward Japanese bonds. As a result, ADIA changed its benchmark. He explained that ADIA had restructured its emerging market debt portfolio to reflect the major shift away from dollar denominated debt to local currency debt. Villain, who manages a Middle East Fund, explained that the Middle East was "starting to be a real place to invest." Regional economies were growing rapidly, not just because of high oil prices, but from increased economic openness. It was possible to make large returns investing in the Middle East as the demand for capital outstripped local supply. Regional markets had boomed over the last two years, but recently had corrected to a more normal 15-20 price/earnings ratio. Al-Kindi noted that the Ministry of Economy, in an effort to control the massive drop in market capitalization following on recent IPOs had stopped banks from increasing capital and financing IPOs.

Central Bank's Portfolio

¶12. (C) Governor Al-Suwaidi explained that since the UAE dirham was pegged to the dollar, dollar interest rates were central to the UAE's monetary policy. Over 98 percent of the Cntral Bank's reserves were in dollar denominated assets. The question of whether or not to take Treasuries or corporate bonds was more of a question of returns, he noted. Saef Al-Shamsi, the Central Bank's Executive Director for Treasuries explained that preservation of capital and liquidity were higher priorities than rates of return, but acknowledged that the Central Bank's board set benchmarks based on the Bank's yearly budget. The Central Bank invests largely in short and medium term debt instruments, by mandate it is limited to securities with maturities of seven years or less. The current focus is on agency bonds for interest rate protection. Currently, it is investing in shorter term securities since returns are higher and risks are lower. The Central Bank does not invest in inflation indexed bonds

Dubai Holding and Dubai Investment Group

¶13. (C) Saud Ba'alawy CEO of Dubai Holdings subsidiary Dubai Investment Group briefed on Dubai Holding's investment portfolio. Real estate makes up about 20-25 percent of its assets (with the majority of investments in the U.S.) The remainder of the company's portfolio was in equities. Ba'alawi explained that the U.S. had gotten pricy in term of real estate and that Dubai Investment Group was selling down its U.S. real estate in favor of Europe.

¶14. (C) On the portfolio side, the company was about half U.S., 10 percent Europe, and the rest in the Middle East and South East Asia. Ba'alawy did not see that allocation shifting over the next five years. He noted that the company would never get into the U.S. banking system, since the regulations were too onerous. Dubai Investment Group started with relatively straightforward real estate investment, but

ABU DHABI 00001472 004 OF 004

would likely diversify over the next five years.

¶15. (C) Ba'alawy said that his company was also looking at the Islamic financial market and would be converting Dubai Bank into an Islamic financial institution. He argued that Islamic investments represented the only true alternatives to conventional investment and that the growth potential was very strong. He preferred Islamic investments for his personal portfolio, although he noted that as a company Dubai Investment Group would invest where the returns were. Islamic finance was still immature and had a long way to go in developing professionalism and investment products.

¶16. (C) Comment: All of the UAE federal and emirate level

officials were "on message" that the relationship was more important than a commercial deal. It was fairly clear that at least some had coordinated their message. MinState Kharbash openly admitted that he had called Governor Al-Suwaidi both before Al-Suwaidi's meeting with U/S Quarles and after that meeting ended. The tone of the meetings was uniformly positive; with all of the officials stressing that the anger over DP World reflected that of "the man on the street." Although there were references to the ongoing FTA negotiations, most interlocutors did not dwell on them. End Comment.
SISON